



DEPARTMENT OF THE TREASURY

OFFICE OF PUBLIC AFFAIRS

EMBARGOED FOR DELIVERY
June 2, 2004

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Testimony of
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Before the
Committee on Agriculture
United States House of Representatives

June 2, 2004

Thank you Chairman Goodlatte, Ranking Member Stenholm and members of the Committee for this opportunity to testify today on the Federal Agricultural Mortgage Corporation (commonly known as Farmer Mac). Our Nation's interest in maintaining strong agricultural credit markets that serve the needs of farmers and ranchers remains strong. The Federal government has established a number of programs or entities that seek to supplement the private sector's efforts in meeting the credit needs of Rural America. Farmer Mac is one such entity, a government sponsored enterprise (GSE) established by Congress in 1987 to address perceived inefficiencies in the allocation of mortgage credit to agricultural real estate. Publicly traded GSEs such as Farmer Mac are not backed by the full faith and credit of the United States, nor do they receive funding from the United States. However, such GSEs do enjoy a limited set of benefits not generally available to other financial institutions.

Farmer Mac was created in the aftermath of the farm financial crisis of the mid-1980s, which many observers linked to the predominance of variable rate mortgages. Farmer Mac was envisioned to operate along the lines of the successful secondary markets for residential mortgages and improve the opportunities for farmers and ranchers to obtain long-term fixed rate mortgages. The idea was that farm real estate mortgages would be originated by participating lenders, pooled by third party financial institutions, guaranteed by Farmer Mac, and sold to investors in the form of securities. Originators would use the proceeds from the sale of loans to make new loans, enhancing the competitiveness of agricultural real estate mortgage markets, and expanding the supply of long-term credit available for farmers and ranchers.

The initial structure of Farmer Mac, however, proved unsuccessful and by 1995 Farmer Mac had low business volume, its capital was depleted, and the anticipated secondary market in agricultural real estate mortgages had not developed. Congress decided to act the following year to significantly alter Farmer Mac's structure with the Farm Credit System Reform Act of 1996 (the 1996 Act). The 1996 Act permitted Farmer Mac to directly act as pooler of agricultural real estate mortgages and it eliminated the requirement that loan originators and poolers retain a 10 percent subordinated participation interest in each securitized loan pool.

Since 1996, Farmer Mac's business operations have improved. Total assets have increased from \$512 million at the end of 1995 to \$4.3 billion at the end of 2003. Farmer Mac had its first profitable year in 1996, and Farmer Mac's net income totaled \$27 million in 2003.

Despite Farmer Mac's improving financial results, as the General Accounting Office (GAO) noted in its November 2003 report, Farmer Mac poses a number of questions for policy makers to consider. In particular, today I would like to focus on three such issues: Farmer Mac's mission achievement; regulatory issues associated with Farmer Mac, including the perception of the Treasury Department's oversight role; and the Treasury Department's perspective on Farmer Mac's line of credit.

Farmer Mac's Mission Achievement

To evaluate the mission of a GSE like Farmer Mac, it is important to understand the reason why Congress created such an entity and what powers Congress provided the entity to accomplish its purpose. Unlike some of the other GSEs, Farmer Mac's enabling legislation does not contain an explicit, prescriptive mission; instead, its broad mission statement refers to Farmer Mac providing a secondary marketing arrangement for agricultural real estate mortgages that would generally improve the credit availability to farmers and ranchers.

One useful way to evaluate Farmer Mac's broad statutory purpose is to consider whether Farmer Mac has contributed to the development of an active secondary market in agricultural real estate mortgages, much like the secondary market that exists for residential housing mortgages. The secondary market for residential housing mortgages is characterized by a wide array of investors who on any given day are buyers and sellers of mortgage-backed securities. GSEs such as Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System have roles in this market, as does a wholly-owned government corporation – Ginnie Mae; but other institutions, such as commercial banks, thrifts, credit unions, mutual funds, insurance companies, and pension funds also have significant investments in mortgage-backed securities.

Similarly liquid markets for agricultural mortgage backed securities (AMBS) do not yet exist. Farmer Mac operates two main AMBS programs. Under the Farmer Mac I program, Farmer Mac purchases agricultural mortgages that meet Farmer Mac's underwriting, appraisal, and documentation standards. Then Farmer Mac issues and guarantees the timely payment of principal and interest on AMBS backed by such mortgages. Under the Farmer Mac II program, Farmer Mac purchases the guaranteed portions of loans guaranteed by the United States Department of Agriculture and guarantees the AMBS backed by those USDA-guaranteed portions. Farmer Mac may retain its guaranteed securities in its portfolio or sell them to third parties.

The amount of AMBS held by outside investors fell dramatically between 1998 and 2002 from about \$600 million to about \$367 million. As a portion of total AMBS outstanding, the amount of AMBS held by outside investors declined from 52 percent in 1998 to 19 percent in 2002. As noted by GAO, because Farmer Mac holds so much of its own guaranteed securities as investments, no active secondary market has developed. In 2003, the amount of AMBS held by outside investors did increase to about \$1 billion, or 40 percent of all Farmer Mac AMBS outstanding; however, this increase was due to a loan participation swap that Farmer Mac entered into with a Farm Credit System institution in 2003. Under this loan participation swap, Farmer Mac replaces loans guaranteed under its Long Term Standby Purchase Commitment (LTSPC) program with an AMBS. Thus, while the participation swap transaction increased AMBS held by outside investors, it did not increase the outstanding credit guarantees of Farmer Mac. Even with this substantial increase in AMBS outstanding, Farmer Mac continues to hold more than twice as many loans and AMBS in portfolio as it sells to investors. Absent a more aggressive effort by Farmer Mac to sell its AMBS to outside investors, it is difficult to perceive of an active secondary market for AMBS developing.

Another way to consider Farmer Mac's mission achievement is to determine if it is broadly providing support for agricultural credit that is not being provided by other credit providers. There are many providers of credit to farmers and ranchers, including commercial banks, insurance companies, the Farm Credit System, and specialized agricultural credit providers. Farmer Mac supplements these institutions' activities by issuing debt in capital markets and purchasing agricultural real estate mortgages or AMBS. In that sense, Farmer Mac is providing a secondary market outlet for lenders to dispose of loans, much the same way that other financial institutions would purchase or participate in agricultural real estate mortgage loans from one another. If the goal of creating Farmer Mac was to create another specialized agricultural lender, as opposed to developing a viable secondary market for AMBS, then Farmer Mac has been more successful in achieving its mission. Whether such an activity constitutes a meaningful public mission is one that Congress should carefully consider.

Another mission evaluation issue is Farmer Mac's investments in non-mission-related assets (i.e., non-agricultural assets). Farmer Mac continues to maintain the highest percentage of non-mission investments among all the GSEs. As of year-end 2003, Farmer Mac's investment portfolio accounted for 25 percent of Farmer Mac's total assets with the majority of Farmer Mac's remaining assets being its own AMBS. Farmer Mac's investment portfolio has increased from \$150 million as of year-end 1996 to \$1.7 billion as of year-end 2003. In 2003, 22 percent of Farmer Mac's interest income was generated from its investment portfolio.

Holding relatively high proportions of non-mission investments invites speculation that GSE status is being used to generate what amount to arbitrage profits. Farmer Mac initially justified its build-up of investments in the latter part of 1990s on the grounds that the corresponding increase in debt issuance would improve capital market recognition of Farmer Mac and the pricing of its securities. It was then argued that improved pricing on Farmer Mac debt securities would be passed on to farmers in the form of lower mortgage rates. Non-mission investments have also been viewed by some as providing a source of liquidity. All financial institutions should maintain a prudent amount of liquidity. The question of how much non-mission investments are necessary for Farmer Mac's liquidity purposes has been the source of debate over several years. We understand that the Farm Credit Administration is about to issue a proposed rule on this issue, and we look forward to following the progress of that rulemaking.

Regulatory Oversight of Farmer Mac

The Farm Credit Administration (FCA) is the regulator of Farmer Mac. The Treasury Department does not have any direct regulatory oversight responsibilities with respect to Farmer Mac. However, on December 22, 1995, the House and Senate Agriculture Committees asked the Treasury to jointly monitor Farmer Mac's financial condition with FCA throughout the capital deferral period and beyond if necessary. The capital deferral period was established as part of the Farm Credit System Reform Act of 1996 and effectively prohibited FCA from implementing a risk-based capital rule for Farmer Mac prior to February 10, 1999. The FCA Board approved a final Farmer Mac risk-based capital rule on February 21, 2001, the final rule became effective on May 23, 2001, and Farmer Mac was required to be in compliance after a 1-year trial period that ended on May 23, 2002.

Treasury's role under the joint monitoring request has consisted of reviewing the semi-annual report that FCA sends to Congress, periodically discussing Farmer Mac's progress with FCA officials, and on a few occasions submitting comments to FCA that focused on broader policy issues associated with Farmer Mac. We have appreciated the close working relationship we have had with FCA in conducting the joint monitoring requested by Congress, but at this time, with the capital deferral period long over, there will be no continued formal relationship with FCA on the joint monitoring of Farmer Mac. FCA has developed a useful semi-annual report, which, as we understand, it will continue to provide to Congress. It would be useful for Treasury also to receive a copy of the final report. However, having FCA provide an advance copy of the report for Treasury to review, or having Farmer Mac or FCA continue to reference a joint monitoring arrangement with Treasury, may inadvertently provide the false impression that Treasury exercises some form of oversight of, or responsibility for, Farmer Mac. Treasury plays no such role.

While Treasury does not have any regulatory supervision responsibilities with respect to Farmer Mac, just as Treasury does not have with the other financial institutions (including the other GSEs), Treasury has an interest in monitoring the activities of Farmer Mac and the FCA. An issue that has periodically come up in FCA rulemaking, which the GAO report raised and we have also raised in the past, is Farmer Mac's relationship under certain transactions with members of the Farm Credit System. In particular, under the LTSPC program, Farmer Mac effectively acts as an insurer of mortgages held by Farm Credit System institutions. LTSPC transactions create regulatory capital arbitrage opportunities for Farm Credit institutions. Under this arrangement, a Farm Credit institution can carry its agricultural mortgages at a 20 percent risk weight, rather than 100 percent, which in turn lowers its regulatory capital requirement for these loans from 7 percent to 1.4 percent. Farmer Mac must hold 0.75 percent in capital against these loans under its minimum capital requirement (which appears to be the binding requirement at this time). Thus, the combined regulatory capital for these loans is just over 2 percent compared to the Farm Credit institution's 7 percent capital requirement on these loans prior to the transaction. This may raise some particular concerns because Farmer Mac is partially owned by Farm Credit institutions.

Outstanding LTSPC guarantees have increased from \$575 million as of year-end 1999 to \$2.3 billion as year-end 2003. The GAO also noted concerns with the LTSPC program regarding

Farmer Mac's liquidity and concentration risk. Over the last few years, FCA Board members have indicated an awareness of the potential for capital arbitrage with the LTSPC program and they have taken some recent actions to address concentration risk within the Farm Credit System.

Farmer Mac's Line of Credit with Treasury

As noted by GAO, there appears to be some confusion over how and under what terms Farmer Mac would have access to its line of credit with Treasury. This issue was brought to the forefront in 1997 when Treasury submitted comments to FCA on a proposed regulation that would govern any future conservatorship or receivership for Farmer Mac. That letter described Treasury's position regarding Farmer Mac's line of credit as follows:

The Farm Credit Act specifies the circumstances allowing Farmer Mac to request the Treasury Secretary to purchase Farmer Mac obligations. Farmer Mac must certify that the proceeds from issuing obligations to the Treasury are necessary to fulfill Farmer Mac's guarantee obligations, and it must have exhausted its reserves. Treasury's obligation extends to Farmer Mac only in the prescribed circumstances, and is not a blanket guarantee protecting Farmer Mac's guaranteed securities holders from loss. Nor is the purpose of the Treasury's obligation to protect Farmer Mac shareholders or general creditors. Thus, we have serious questions as to whether the Treasury would be obligated to make advances to Farmer Mac to allow it to perform on its guarantee with respect to the securities held in its own portfolio – that is, where Farmer Mac's guarantee essentially runs to Farmer Mac itself. Indeed, Farmer Mac's guaranteed securities must, by statute, carry a disclaimer stating that these securities are not guaranteed by the federal government.

Treasury has not changed its position on this issue. Investors in Farmer Mac securities should rely on the underlying credit quality of Farmer Mac when making investment decisions, not on any potential access to a line of credit with the Treasury.

Conclusion

Our Nation's interest in maintaining strong agricultural credit markets that serve the needs of farmers and ranchers remains strong. Farmer Mac has improved its business prospects since it was granted new powers by Congress in 1996, and its capital position has improved over the years. FCA completed its implementation of Farmer Mac's risk-based capital standards and has been considering other issues associated with risk concentration within the Farm Credit System and Farmer Mac's non-mission investments. While Farmer Mac's role in agricultural mortgage markets has increased, whether Farmer Mac's increased business activity contributes to achieving a significant public purpose remains an issue that Congress should continue to evaluate.